

EXHIBIT E

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**

Washington, DC 20549

FORM 10-K

- ☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002
OR
☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**
FOR THE TRANSITION PERIOD FROM _____ TO _____.
COMMISSION FILE NUMBER: 0-24509

ALLEGIANCE TELECOM, INC.

(Exact Name of Registrant as Specified in its Charter)

DELAWARE
(State of Incorporation)
9201 NORTH CENTRAL EXPRESSWAY
DALLAS, TEXAS
(Address of Principal Executive Offices)

75-2721491
(IRS Employer Identification No)
75231
(Zip Code)

(214) 261-7100

Registrant's Telephone Number, Including Area Code

Securities Registered Pursuant to Section 12(b) of the Act
NONE

Securities Registered Pursuant to Section 12(g) of the Act
COMMON STOCK, PAR VALUE \$.01

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that it was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days Yes ☒ No ☐

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K ☐

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes ☒ No ☐

The aggregate market value of the registrant's voting stock held by non-affiliates of the registrant as of June 28, 2002 (the last business day of the registrant's most recently completed second fiscal quarter) was approximately \$158.6 million. Shares of common stock held by each executive officer and director have been excluded since those persons may under certain circumstances be deemed to be affiliates. This determination of executive officer or affiliate status is not necessarily a conclusive determination for other purposes.

The registrant has 124,778,137 number of shares of common stock outstanding as of March 26, 2003.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement for the annual meeting of stockholders for the fiscal year ended December 31, 2002, which will be filed with the SEC by April 30, 2003, are incorporated by reference into Part III of this Form 10-K.

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FOR THE YEAR ENDING DECEMBER 31, 2002

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INTRODUCTION

Allegiance Telecom, Inc. and its subsidiaries are generally referred to in this report as "we," "our company" or "Allegiance."

FORWARD-LOOKING STATEMENTS

Certain statements in this report constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, and we intend that such forward-looking statements be subject to the safe harbors created by this law. You generally can identify these statements by our use of forward-looking words such as "plans," "estimates," "believes," "expects," "may," "will," "should" or "anticipates" or the negative or other variations of such terms or comparable terminology, or by discussion of strategy that involve risks and uncertainties. We often use these types of statements when discussing our plans and strategies, our anticipation of revenues from designated markets, and statements regarding the development of our businesses, the markets for our services and products, our anticipated capital expenditures, operations support systems or changes in regulatory requirements and other statements contained in this report regarding matters that are not historical facts.

We caution you that these forward-looking statements are only predictions and estimates regarding future events and circumstances. We cannot assure you that we will achieve the future results reflected in these statements. The risks we face that could cause us not to achieve these results are many and include, but are not limited to, the risks discussed in this report as well as our ability to do the following in a timely manner, at reasonable costs and on satisfactory terms and conditions:

- successfully market our services to current and new customers,
- retain our customers,
- provide quality customer service,
- interconnect with and lease network elements from incumbent local carriers,
- electronically interface with incumbent local carriers,
- develop cooperative working relationships with other carriers,
- develop efficient operations support systems and other back office systems (including, but not limited to, provisioning and billing),
- successfully and efficiently transfer new customers to our service,
- identify, finance, complete and integrate suitable acquisitions,
- borrow under our credit facilities or borrow under alternative financing sources,
- comply with our credit facilities and other financing agreements,
- install, maintain and operate switching facilities and other network equipment,
- maintain efficient interconnection peering with other Internet backbone providers at reasonable rates,
- purchase equipment at reasonable prices, and
- obtain leased fiber optic line capacity, rights-of-way, building access rights and any required governmental authorizations, franchises and permits.

Regulatory, legislative and judicial developments could also cause actual results to differ materially from the future results reflected in such forward-looking statements. You should consider all of our subsequent written and oral forward-looking statements only in light of such cautionary statements. You should not place undue reliance on these forward-looking statements and you should understand that they represent management's view only as of the dates we make them.

PART I

ITEM 1. BUSINESS

OVERVIEW

We are a facilities-based national local exchange carrier that provides integrated telecommunications services to business, government and other institutional users in major metropolitan areas across the United States. We offer "one-stop shopping" for voice, data, and integrated communications services (including local, long distance, Internet, data colocation, web hosting and customer premise equipment sales and maintenance services), with convenient, integrated online billing, plus a single point of contact for sales and service. Our principal competitors are incumbent local exchange carriers (also known in the industry as "ILECs"), and to a lesser extent, long distance carriers as well as other integrated communications providers.

We seek to attract and retain customers by offering a full suite of turnkey product offerings and personalized customer care. The majority of our customers are small and medium-sized businesses that generally lack in-house telecommunications expertise and, more importantly, have historically been underserved by the ILECs. Although the number of lines serviced for each customer varies significantly, our primary focus is on the small to medium-sized business customer who has between 4 and 24 lines. We also offer services to large businesses (national customers with multiple locations), government organizations and other institutional users who typically obtain telecommunications services from a number of suppliers. With respect to these customers, we focus primarily on capturing a significant portion of their local exchange, intraLATA toll and data traffic. We also augment our core business strategy by selectively supplying wholesale services, including equipment colocation and facilities management services, to other carriers.

We began operations in late 1997 with an objective to grow rapidly and establish our company as a national communications provider covering the major metropolitan areas across the United States. By the end of 2001, we had completed the network rollout in our 36 targeted markets: Atlanta, Austin, Baltimore, Boston, Chicago, Cleveland, Dallas, Denver, Detroit, Fort Lauderdale, Fort Worth, Houston, Long Island, Los Angeles, Miami, Minneapolis/St. Paul, New York, Northern New Jersey, Oakland, Ontario/Riverside, CA, Orange County, Philadelphia, Phoenix, Pittsburgh, Portland, Sacramento, St. Louis, San Antonio, San Diego, San Francisco, San Jose, Seattle, Tampa, Washington, D.C., West Palm Beach/Boca Raton and White Plains, NY.

Allegiance Telecom, Inc. was incorporated in April 1997 in the state of Delaware. Information about our company is available on our web site at <http://www.algx.com>. We are not including the information contained on our website as a part of, or incorporating it by reference into, this annual report on Form 10-K. As of March 1, 2003, we are making available free of charge (other than an investor's own Internet access charges) through our website our annual report on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, and amendments to these reports, on the same day after we electronically file such material with, or furnish such material to, the Securities and Exchange Commission. In addition, we plan to disclose on our website, a copy of our code of ethics and any amendments to or waivers from that code that are required to be publicly disclosed pursuant to rules of the Securities and Exchange Commission.

PRODUCTS AND SERVICES

We offer a robust set of local, long distance, broadband/Internet access and Internet related services, bundled and carrier-oriented wholesale services, plus end-user equipment sales and maintenance services. This product and service set is targeted to meet the needs of small to medium-sized businesses, large businesses with multiple locations and Internet and network service providers.

Local Telephone Services. We offer local telephone services, including basic local voice services and vertical features, such as call forwarding, call waiting, and call transfer, advanced call management capabilities such as calling number identification/calling name identification, automatic call back and distinctive ringing, plus enhanced services such as voice mail and inside wire maintenance. We also provide PBX-oriented access services such as direct-inward-dialing and direct-outward-dialing over T1 Voice and ISDN Primary Rate Interface local access interfaces. We predominantly utilize our own switching and back office infrastructure to deliver these services, and lease local loops from the incumbent local exchange carrier to connect to customer locations.

Long Distance Services. We offer a full range of in-state, inter-state and international long distance services and calling plans to customers who purchase our local service. Our services include "1+" outbound calling, inbound toll free service and complementary services such as calling cards, operator assistance and conference calling, plus bundled branch-to-branch calling for multi-location customers who choose our Independence or Allegiance Select purchasing plans. These long distance services are provisioned via resale arrangements with several major interexchange carriers.

Broadband and Other Internet Services. We are a Tier 1 Internet access provider offering high-speed data transmission services, such as dedicated broadband Internet access (which allows large quantities of data to be transmitted at high-speeds over the Internet to and from the customer's premises), and wide area network interconnection (which allows file and resource sharing among geographically distributed workgroups). These services are offered at transmission speeds that range from 256Kb/s to 45Mb/s. In addition to Internet access, we offer domain name registration, web hosting, email, and colocation services. We utilize our own Tier 1 Internet backbone and back office infrastructure to deliver these services, and lease local loops from the incumbent local exchange carriers or other competitive access providers to connect to customer locations.

Bundled Services. We offer a variety of bundled solutions. These include voice/long distance promotional offers, as well as our standard Integrated Access ("IA") and Total Communications Options ("TCO") voice/long distance/Internet access offerings. Our flagship product is the Total Communications Options bundled voice/long distance/Internet access service offering. With the IA and TCO offerings, we provide customers with integrated voice and Internet access over a single broadband line with configurations ranging from 6 to 20 voice channels and 256 Kb/s to 1.2 Mb/s of Internet access.

Wholesale Services. We have pursued deal-driven opportunities to leverage our national voice and data backbone to provide wholesale network services to other regional and national service providers. Accordingly, we have deployed a versatile set of wholesale network services to enable swift capitalization of these opportunities. These services include: equipment colocation, managed modem ports, DS1/DS3 dedicated Internet access, Internet protocol ("IP") traffic aggregation and DS3/OC-N IP Transit.

CPE Sales and Service. Our Shared Technologies subsidiary is among the larger CPE maintenance service providers and CPE integrators and distributors in the U.S., with more than 5,000 customers nationwide in more than 7,000 locations. Shared Technologies sells, installs and maintains customer premise equipment ("CPE") including PBX and key telephone systems and other telephony and data equipment. Target customers include medium to large commercial businesses, national equipment accounts, governmental (federal and state) agencies and hospitals. The Shared Technologies business strategically enhances our present small to medium-sized and growing national accounts businesses as these customers seek suppliers capable of supplying a complete communications solution. With Shared Technologies, we offer a truly complete communications solution to corporate customers, including local and long distance voice and Internet access services, bolstered by a full suite of customer premise communications equipment and service offerings.

SALES, MARKETING AND CUSTOMERS

We have deployed a robust suite of services and products targeted to meet the needs of the nearly 3.3 million business prospects within our current national footprint. Through systematic analysis and segmentation of the overall market opportunity, we are able to precisely identify attractive customer prospects. Customer acquisition is accomplished, largely, through a consultative selling process that leverages this prospect information, our direct sales force and extended sales force (agents and partners), and our product and service set.

To best seize this sizeable opportunity, we have organized our sales organization to focus on distinct customer segments within our network footprint. Our retail sales teams and agents are focused on the small and medium-sized business customer segment, while our national accounts teams are focused on multi-location, national companies. Our commission plans and incentive programs for both channels are designed to reward and retain top performers, improve sales quality and productivity, and encourage strong customer relationships and customer retention.

Our retail teams are generally organized into teams of eight account executives, a sales manager and a sales support specialist. Additionally, the retail channel includes account consultants whose primary focus is retention and growth of key retail accounts. The number of retail teams and account consultants in each market is sized based upon available opportunity.

Our national accounts teams focus on multi-location, national companies, and are staffed with account managers who focus on relationship building with named accounts. National accounts teams are assisted by sales engineers, program managers, service coordinators, and account retention managers. These support personnel provide pre-and-post-sale customer support. Through consultative selling, we are able to offer one-stop shopping to these companies by leveraging our nationwide network footprint and robust product set. We believe that we have a competitive advantage within this customer segment because the product and service offerings of most of our competitors, including the ILECs, are regional, not national in scope.

To meet the objectives of (a) selling into our existing network capacity, and (b) methodically identifying opportunities within our network footprint, these teams use an internally developed, integrated territory and sales management system. This system identifies attractive prospects and existing customer up-sell/cross-sell opportunities, generates the associated leads, and manages the sales process. This system also provides an updated database for customers and prospects which facilitates a smooth transition in the event an account executive leaves our company. Central to the execution of this new system is the routine distribution of updated network capacity and marketing intelligence to our sales force. Through this system, we are positioned to systematically achieve close alignment of retail and national accounts execution to corporate goals and objectives.

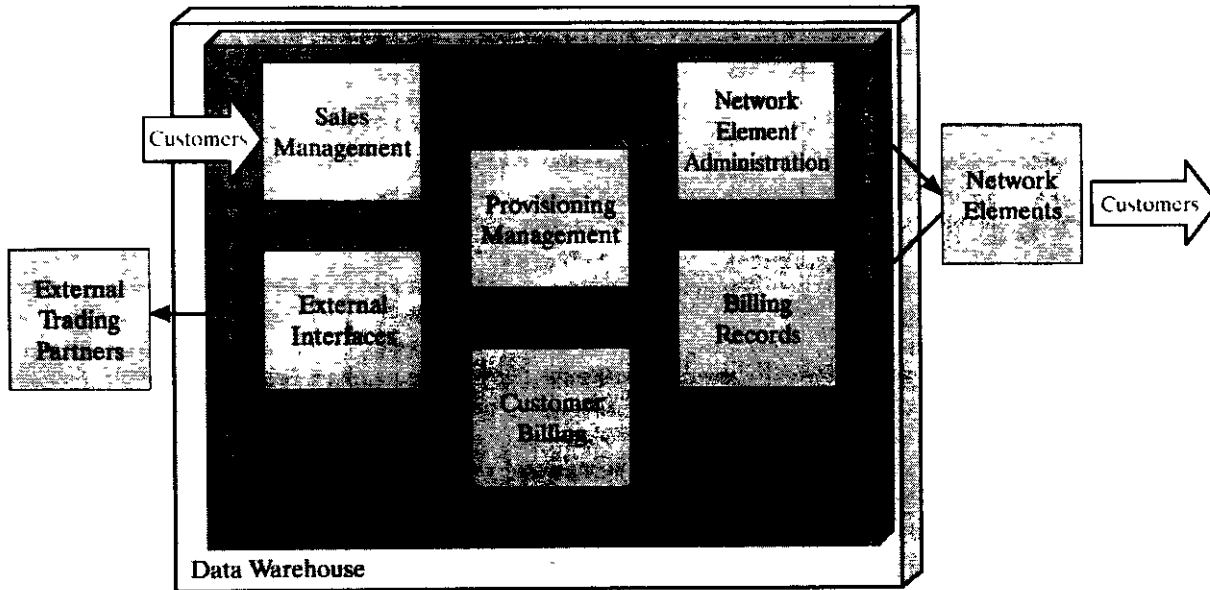
Our wholesale channel is organized by customer segment. This channel is staffed with account managers who have experience and relationships with large wholesale/corporate accounts. Wholesale account managers are supported by pre-sales engineers, program managers and service coordinators. These individuals provide pre- and post-sale account support.

We also have an active and growing network of agents and partners who complement our retail, national accounts and wholesale sales efforts. The role of the agent channel manager is to develop and grow relationships with local key system, PBX, and data integrators to drive additional sales of our products and services. Our national accounts and wholesale channels also employ a similar partner program aimed at creating and maintaining relationships with larger national resellers (e.g., MegaPath).

Our largest customer for the year ended December 31, 2002, Level 3 Communications, Inc. (as assignee to Genuity Solutions Inc.'s Integrated Network Solution Purchase Agreement with us), accounted for 12% of our total revenue in 2002.

INFORMATION SYSTEMS

Telephony Systems. Providing local voice and data services is a complex process that requires extensive coordination between the customer's old and new service providers. Most of our sales involve us working closely with the ILECs to efficiently move customers from the networks of the ILECs and other competitive carriers to ours. We believe that a key to success in our business is the ability to develop customized information systems and procedures that allow us to process large order volumes and provide the necessary customer service. As a result, we have devoted significant resources to this aspect of our operations. Our information systems are developed to enable us to enter, schedule, provision, and track a customer's order from the point of sale to the installation and testing of service. They are designed to interface with trouble management, inventory, billing, collection and customer service systems. We have invested substantial effort and funds into building our information systems to include these capabilities. The required high-level information requirements to support facilities-based services are depicted in the following figure and are briefly described below.



Order Management We have created a custom application for order management that allows field sales to enter the orders and acts as the customer system of record. We have developed integration software for this system to interface with MetaSolv's order management software (used for provisioning workflow and management) to allow all customer information to flow electronically into MetaSolv's Telecom Business Solutions software with no manual re-entry of the data. A key element of both systems is the ability to monitor (in real time) the progress of orders through the system and to provide up-to-date data.

Provisioning Management Our order management software, together with the proprietary processes developed by us to optimize the usefulness of this software, supports the design and management of the provisioning process, including circuit design and work flow management. The system has been designed to permit programming into the system of a standard schedule of tasks, which must be accomplished in order to initiate service to a customer, as well as the standard time intervals during which each such task must be completed. This way, when a standard order is selected in the system, each required task in the service initiation process can be efficiently managed to its assigned time interval.

External Interfaces (Electronic Bonding) Several external interfaces are required to initiate service for a customer. While some of these are automated via gateways from the order management software, the most important interfaces (those to the ILEC) have historically been accomplished via fax or email.

For example, with a manual process, when a new customer requests a change in service from the ILEC to our company, we had to fax a local service request to the ILEC. An employee of the ILEC would manually input the information into the ILEC's system, thereby increasing the chance that an error may occur due to multiple data entries or misplaced faxes. As a result of the high incidence of error, activation of a new service order through a manual process takes much longer and the ILECs in some instances charge more for such manual orders. In an effort to make this process more efficient and less costly, we have electronically bonded with all of the regional Bell operating companies with respect to access service requests and local service requests in all of our markets. Electronic bonding allows us to access data from the ILEC, submit service requests electronically, reduce our costs and more quickly attend to errors in the local service request form since an order is bounced back immediately if the ILEC determines that there is a mistake on the form. We are currently implementing electronic bonding of pre-order information providing the customer service record and service address validation with the ILEC databases as well as electronic bonding for trouble ticket creation in the ILEC customer service applications.

Customer Billing and Billing Records In 1997, we started business using a billing services provider. Over time, we have licensed and implemented an in-house billing system, Singl eView from ADC-Saville Corporation, which has enabled us to build even tighter integration between billing and the rest of our operations support systems. Both billing systems are now fully flow-through automated for the core, high-volume products so that no manual re-entry into the billing systems is required.

Data Warehouse We have built a corporate repository of key performance metrics that are housed in a central data warehouse. The warehouse incorporates all the business rules around managing these metrics and can be accessed via traditional reports (all delivered online from our company's Intranet), ad-hoc analysis tools and our customer relationship management system. Both operational and customer-centric data is stored in the data warehouse.

Application Integration As critical as each component of the operational support system is, the integration between the systems is the key to success in providing highly scalable and cost efficient service. We have been heavily focused on integrating the various in-house and purchased applications. This integration employs a common platform enabling fast time-to-market and a central repository for all major business transactions. This has enabled us to reduce re-entry of data from system to system, thereby increasing productivity and quality, as well as reducing cycle times.

Other Systems. In addition to the information systems for our telephony services, we also have information systems for our Internet backbone services as well as our customer premise equipment sales and maintenance businesses.

Our Shared Technologies customer premise equipment sales and maintenance business provides an exclusive tool called KTWare which allows customers to have real time access to customer account information via the Internet. KTWare allows our Shared Technologies customers to place service and move/add/change orders online, view the status of service and move/add/change trouble tickets online, view any customer network alarms online, view monthly invoices online, view account team information and escalation procedures online, and access E-book services and download customer data management information. Our Shared Technologies business also provides the Guardian Services plan which allows customers to access Sourcebook, e-Book and Disaster Recovery services. Source Book provides a static snapshot of a customer's inventory and audit information associated with a customer's Nortel PBX equipment. E-Book services provide monthly on-line updates of any modifications made to a customer's Nortel PBX equipment. Disaster Recovery services allows Shared Technologies customers to order a back-up database of a customer's PBX configuration in case such information is lost as a result of a disaster. In addition, the Guardian Services program can provide Shared Technologies' customers traffic study reports, toll fraud and toll abuse analysis and user guide information. KTWare is highly integrated with the custom-built backoffice systems at Shared Technologies.

In addition to our telephony backoffice systems and systems at Shared Technologies, we also operate legacy support systems associated with our Internet backbone line of business. These systems are developed to deal with the higher capacity, lower volume and more customized product provisioning processes associated with high capacity Internet backbone and broadband services.

As we bring the Internet backbone and the Shared Technologies businesses into tighter integration with our core offerings, systems integration projects will need to be instigated and completed to ensure overall business process integration.

NETWORK ARCHITECTURE

Our nationwide network is controlled and monitored by our network operations control centers located in Dallas, Texas and Greenbelt, Maryland. We have locally-based technicians to maintain each switch and other telecommunications equipment, as well as centrally-based engineers to ensure that the equipment is designed properly and that the hardware and software components are current.

Telephony Network. An important element of our telephony network is the installation of Lucent Series 5ESS®-2000 digital switches and related equipment at a central location in each market. As of December 31, 2002, we had deployed 31 Lucent Series 5ESS®-2000 digital switches to serve our 36 markets.

We lease local network transport facilities from the ILEC and/or one or more competitive access providers in order to connect our switch(es) to all ILEC tandem offices and major ILEC central offices serving the central business district and outlying areas of business concentrations in each market. In order to reach our customer base, we place integrated digital loop carrier systems and related equipment in each of the ILEC central offices in which we are colocated. As each customer is signed up, we lease unbundled local loops from the ILEC to deliver our services to the customer. Initially, leasing local network transport facilities allows us to begin operations in a new market more quickly and generally at a lower upfront cost than building these facilities; however, we may choose to purchase fiber technology such as dark fiber, as and when we experience sufficient growth in our traffic volume and customer base or as other factors make fiber technology more attractive. "Dark fiber" means fiber that does not have the electronics at either end to transmit information and is "dark" because no light is transmitted through it until the electronics are installed. We have already implemented this next phase by acquiring indefeasible rights to use fiber from various vendors in 24 of our markets. Building fiber rings through the purchase of dark fiber provides us with a reliable, diverse and robust connection to many of our central office locations throughout a market. As of December 31, 2002, we had dedicated fiber rings in the following 24 markets: Austin, Baltimore, Boston, Chicago, Dallas, Denver, Detroit, Ft. Worth, Houston, Long Island, Los Angeles, New York City, Northern New Jersey, Philadelphia, Phoenix, Pittsburgh, Portland, San Antonio, San Diego, San Francisco, St. Louis, Seattle, Washington, D.C. and White Plains. We also have acquired long-haul point to point fiber connectivity between several markets in the northeast corridor. We are utilizing this infrastructure to carry our intercity IP backbone and internal network traffic, and using this fiber generally provides us with an improved cost position.

Data Network. Our fully redundant, multi-protocol label switching based backbone is made up primarily of 2.5 Gb/s optical wavelength transport, with OC3C and DS3 circuits serving smaller markets. Multiple paths and the latest switching and routing technology support every node. To provide the fastest, most reliable Internet access, we are privately peered with the largest Tier 1 Internet backbone providers, supplemented by private peering relationships with many smaller regional providers. As of December 31, 2002, we operated 150 core routers. With 12 GigaPops (which is a gigabit point of presence, a network access point that supports data transfer rates of at least 1 Gb/s) throughout the country, we minimize the number of hops (jumps from city to city) from point A to

point B That efficiency allows us to provide better availability, lower latency and lower packet loss that you would expect from a Tier 1 Internet access provider

REGULATION

Our business is subject to federal, state and local regulation

Federal Regulation. The Federal Communications Commission ("FCC") regulates interstate and international telecommunications services, including the use of local telephone facilities to originate and terminate interstate and international calls. We provide such services on a common carrier basis. The FCC imposes regulations on common carriers such as the incumbent local carriers that have some degree of market power as well as carriers without market power, such as our company. The FCC requires common carriers to receive an authorization to construct and operate telecommunications facilities, and to provide or resell telecommunications services, between the United States and international points. Under the Telecommunications Act of 1996, any entity, including cable television companies and electric and gas utilities, may enter any telecommunications market, subject to reasonable state regulation of safety, quality and consumer protection. Since the passage of the Telecommunications Act of 1996, the FCC and the states have adopted rules and decisions to implement the terms of that Act. Those rules and decisions have been subject to numerous legal challenges and appeals which has created a climate of uncertainty.

The Telecommunications Act of 1996 is intended to increase competition. It was designed to open the local services market by requiring incumbent local carriers to permit interconnection to their networks and establishing incumbent local carriers' obligations with respect to

Reciprocal Compensation Requires all local exchange carriers to complete calls originated by competing local exchange carriers under reciprocal arrangements at prices set by the FCC, state public utility commissions or negotiated prices.

Resale Requires all incumbent local carriers and competitive local carriers to permit resale of their telecommunications services without unreasonable restrictions or conditions. In addition, incumbent local carriers are required to offer wholesale versions of all retail services to other telecommunications carriers for resale at discounted rates, based on the costs avoided by the incumbent local carrier in the wholesale offering.

Interconnection Requires all incumbent local carriers and competitive local carriers to permit their competitors to interconnect with their facilities. Requires all incumbent local carriers to permit interconnection at any technically feasible point within their networks, on nondiscriminatory terms, at prices based on cost, which may include a reasonable profit. At the option of the carrier seeking interconnection, colocation of the requesting carrier's equipment in the incumbent local carriers' premises must be allowed, except where an incumbent local carrier can demonstrate space limitations or other technical impediments to colocation.

Unbundled Access Requires all incumbent local carriers to provide nondiscriminatory access to unbundled network elements ("UNEs") including network facilities, equipment, features, functions and capabilities, at any technically feasible point within their networks, on nondiscriminatory terms, at prices based on the ILEC's forward looking costs, which may include a reasonable profit.

Number Portability Requires all incumbent local carriers and competitive local carriers to permit users of telecommunications services to retain existing telephone numbers without impairment of quality, reliability or convenience when switching from one telecommunications carrier to another.

Dialing Parity Requires all incumbent local carriers and competitive local carriers to provide "1+" equal access to competing providers of telephone exchange service and toll service, and to

provide nondiscriminatory access to telephone numbers, operator services, directory assistance and directory listing, with no unreasonable dialing delays

Access to Rights-of-Way Requires all incumbent local carriers and competitive local carriers to permit competing carriers access to poles, ducts, conduits and rights-of-way at regulated prices

Incumbent local carriers are required to negotiate in good faith with other carriers requesting any or all of the above arrangements. If the negotiating carriers cannot reach agreement within a prescribed time, either carrier may request binding arbitration of the disputed issues by the state regulatory commission.

The FCC's rules implementing the incumbent local carrier interconnection obligations described above have been the subject of considerable litigation. On July 18, 1997, the United States Court of Appeals for the Eighth Circuit narrowly interpreted the FCC's power to prescribe and enforce rules implementing the Telecommunications Act of 1996. On January 25, 1999, the United States Supreme Court reversed the Eighth Circuit decision and reaffirmed the FCC's broad authority to issue rules implementing the Telecommunications Act of 1996, although it did vacate a rule determining which network elements the incumbent local carriers must provide to competitors on an unbundled basis. On November 5, 1999, the FCC issued revised rules that largely reaffirmed, and in some respects expanded, the duty of incumbent carriers to offer unbundled network elements and stated its intention to review every three years the unbundling obligations of incumbent carriers. The Court of Appeals for the District of Columbia Circuit remanded, but did not vacate, the FCC's order adopting the revised rules on May 24, 2002. The FCC requested rehearing of the Court's decision, but its request was denied. The Court did, however, stay issuance of the mandate until February 20, 2003 to give the FCC an opportunity to issue an order in its triennial review of the incumbent carriers' unbundling obligations. On February 20, 2003, the FCC announced its decision in the triennial review proceeding. Although the text of the decision has not yet been released, our understanding of the decision is as follows:

- In general, the FCC's triennial review order revised its standard of review for determining when unbundled network elements are made available to competitors. Specifically, the FCC's revised standard recognized the benefits of facilities-based competition and confirmed that continued provision of UNEs is essential to the growth of facilities-based networks such as those operated by us.
- With respect to unbundled switching, the FCC adopted a process whereby the state public utilities commission will consider whether competitors are impaired if they do not have access to Bell companies' switch services on a UNE basis under the regulatory construct known as unbundled network element platform ("UNE-P"). We expect that this state review will result in a review of the hot cut process (transferring a customer from the Bell's systems to our systems) and could potentially enhance our ability to transition new customers to our networks, although we need to see the FCC's specific written order to determine if this is significant.
- The decision also confirms that facilities-based competitive carriers like us can continue to obtain access to loops in almost all markets. The FCC also clarified the conditions under which the Bell companies must make available unbundled loops for competitors. This should reduce the time it takes us to install a customer's services, especially in certain ILEC areas.
- On transport issues, the FCC adopted a standard proposed by us whereby transport will be taken off the UNE list on a route-specific basis when there are two competitive wholesale providers of transport or three self-provisioned transport links by non-ILEC sources. This approach is consistent with our smart-build strategy for local transport of using ILEC facilities only as a transition to dark fiber or the facilities of other providers.

- The FCC decision also is expected to make it easier for competitive carriers like us to obtain Enhanced Extended Links ("EELs"). These are combinations of loops and transport that connect back to the competitive carrier's switch. Although we do not currently use EELs on an extensive basis, this aspect of the triennial review gives us an opportunity to efficiently expand our facilities-based network to additional areas not directly accessed by our current colocation footprint.
- Finally, the FCC is expected to exempt packetized data transmission over hybrid fiber/copper facilities from the UNE rules. The FCC indicated, however, that it will preserve access to high-capacity DS1's, DS3's, dark fiber and copper subloops using time division multiplexing technology. Since virtually all of our current business customers are served using unbundled copper loops or DS1's, the FCC's exemption of packet technology from loop unbundling should not impact our current operations. As new technologies are deployed in the future in the local loop, this ruling by the FCC could cause an adverse impact on our ability to compete with the ILECs for small to medium-sized business customers. Depending on the details of the FCC's written order, we may challenge the FCC order on packet technologies in court since it may violate the Telecommunications Act of 1996 which requires that unbundling be technology neutral and *non-discriminatory*.

The Telecommunications Act of 1996 codifies the incumbent local carriers' equal access and nondiscrimination obligations and preempts inconsistent state regulation. It also contains special provisions that replace prior antitrust restrictions that prohibited the regional Bell operating companies (known in the industry as "RBOCs", there are currently four RBOCs—BellSouth, Qwest, SBC and Verizon) from providing long distance services and engaging in telecommunications equipment manufacturing. Provisions of the Telecommunications Act of 1996 permit a RBOC to enter the long distance market in its in-region states if it satisfies several procedural and substantive requirements, including

- obtaining FCC approval upon a showing that the RBOC has entered into interconnection agreements or, under some circumstances, has offered to enter into such agreements in those states in which it seeks long distance relief,
- the interconnection agreements satisfy a 14-point "checklist" of competitive requirements, and
- the FCC is satisfied that the RBOC's entry into long distance markets is in the public interest.

The FCC has granted approval to the Bell operating companies to provide long distance service in 37 states and the District of Columbia. With their entry into the long distance market, the Bell companies are able to offer their customers both long distance and local telephone service and thereby compete with the "one stop shopping" and bundled service offerings offered by us.

On May 8, 1997, the FCC released an order establishing a significantly expanded federal universal service subsidy regime. For example, the FCC established new subsidies for telecommunications and information services provided to qualifying schools and libraries with an annual cap of \$2.25 billion and for services provided to rural health care providers with an annual cap of \$400 million, and expanded the federal subsidies for local exchange telephone services provided to low-income consumers. The FCC more recently adopted rules for subsidizing service provided to consumers in high cost areas, which may result in further substantial increases in the overall cost of the subsidy program. Providers of interstate telecommunications service, such as us, must pay for a portion of these programs. Our share of these federal subsidy funds is based on our share of certain defined interstate telecommunications end user gross revenues and through the end of 2002, the FCC assessed such payments on the basis of a provider's revenue for the previous year. Beginning in 2003, the FCC will assess such payments based on projected revenues. In November 2002, the FCC issued a Notice of Proposed Rulemaking seeking further comment on whether it should substitute a connection based universal service contribution.

scheme for the current revenue based scheme. Under the FCC's proposal, carriers would contribute to the universal service fund based on the number and capacity of lines or telephone numbers provided to end users.

Under authority granted by the FCC, we resell the international telecommunications services of other common carriers between the United States and international points. The FCC no longer allows carriers to file tariffs stating the rates, terms and conditions for international services.

The FCC also prohibits carriers from filing tariffs stating the rates, terms and conditions for retail interstate services. We still maintain tariffs on file at the FCC for interstate access services. Our tariffs are generally not subject to pre-effective review by the FCC and can be amended on one day's notice. However, the FCC does have jurisdiction to require changes in these tariffs.

Our access services compete with the services provided by the incumbent local carriers. With limited exceptions, the current policy of the FCC for most interstate access services dictates that incumbent local carriers charge all similarly situated customers the same price for the same service. Thus, the incumbent local carriers generally cannot lower prices to certain customers without also lowering charges for the same service to all similarly situated customers in the same geographic area. The FCC has, however, adopted rules that significantly lessen the regulation of incumbent local carriers that are subject to competition in their service areas and provide such incumbent local carriers with additional flexibility in pricing some interstate switched and special access services on a central office specific or customer specific basis. Pricing flexibility relieves incumbent local carriers from regulatory constraints in setting rates for services that are subject to competition and as a result, allows them to react more rapidly to market forces.

For additional information about federal regulation impacting our business, please see the discussion below under "Risk Factors."

State Regulation. The Telecommunications Act of 1996 is intended to increase competition in the telecommunications industry, especially in the local exchange market. With respect to local services, incumbent local carriers are required to allow interconnection to their networks and to provide unbundled access to network facilities, as well as a number of other pro-competitive measures.

State regulatory agencies have regulatory jurisdiction when our facilities and services are used to provide intrastate services. A portion of our current traffic is classified as intrastate and therefore subject to state regulation. To provide intrastate services, we generally must obtain a certificate of public convenience and necessity from the state regulatory agency and comply with state requirements for telecommunications utilities, including state tariffing requirements.

State agencies, like the FCC, require us to file periodic reports, pay various fees and assessments and comply with rules governing quality of service, consumer protection and similar issues. In some states, we are also subject to licensing requirements with respect to our equipment maintenance services. We intend to comply with all applicable state regulations, and as a general matter do not expect that these requirements of industry-wide applicability will have a material adverse effect on our business. However, no assurance can be given that the imposition of new regulatory burdens in a particular state will not impact the profitability of our services in that state.

Local Regulation. We are subject to numerous local regulations such as building codes and licensing. Such regulations vary on a city by city and county by county basis. If we decide in the future to install our own fiber optic transmission facilities, we will need to obtain rights-of-way over private and publicly owned land. There can be no assurance that such rights-of-way will be available to us on economically reasonable or advantageous terms.

State Legislation. In a number of states, the ILECs are sponsoring legislation that would (a) prohibit the state regulatory commission from requiring that ILECs offer unbundled network

elements in addition to those required by the FCC, and (b) prohibit the state regulatory commission from regulating high speed Internet access services—which includes all services and underlying facilities that provide transmission to the Internet or has the capability of transmitting data in excess of generally 144kbps/150kbps (or an ISDN line equivalent of traffic) If this legislation is passed in a state in which we operate, it could have a material adverse effect on our ability to offer broadband access services in that state and limit the state regulatory agencies' ability to create new unbundling requirements on the ILECs

COMPETITION

The telecommunications industry is highly competitive. We believe that the principal competitive factors affecting our business are customer service, competitive pricing, accurate billing and, to a lesser extent, variety of services. Our ability to compete effectively depends upon our ability to maintain high quality, market-driven services at prices that are competitive with those charged by our competitors. To maintain our competitive posture, we believe we must be in a position to match significant price movement of our primary competitors. Many of our current and potential competitors have financial, personnel and other resources, including brand name recognition substantially greater than we have or expect to have in the near term.

Competition for Local Telephone Services. In each of our targeted markets, we compete principally with the existing incumbent carriers serving that area, such as BellSouth, SBC, Verizon and Qwest. We typically price our basic local voice services at a discount to the ILEC's prices for comparable services. One of the objectives of the RBOCs is to be able to offer long distance service in their service territories and they have achieved this goal to a large extent. We believe the RBOCs expect to offset share losses in their local markets by capturing a significant percentage of the in-region long distance market, especially in the residential segment where the RBOCs' strong regional brand names and extensive advertising campaigns may be very successful. Recent reports indicate that Verizon is now the third largest long distance carrier in the country, trailing only AT&T and WorldCom.

We also face competition from other current and potential market entrants, including long distance carriers such as AT&T, WorldCom and Sprint. Each of these players are seeking to enter, reenter or expand entry into the local exchange market. Our competitors also include resellers of local exchange services, cable television companies, electric utilities, wireless carriers and private networks built by large end users. In addition, a continuing trend toward consolidation of telecommunications companies and the formation of strategic alliances within the telecommunications industry, as well as the development of new technologies, could give rise to significant new competitors. We also compete with equipment vendors and installers and telecommunications management companies with respect to certain portions of our business.

The Telecommunications Act of 1996 includes provisions that impose certain regulatory requirements on all local exchange carriers, including our company. The Telecommunications Act of 1996 also grants the FCC expanded authority to reduce the level of regulation applicable to any or all telecommunications carriers, including incumbent carriers. The manner in which these provisions of the Telecommunications Act of 1996 are implemented and enforced could have a material adverse effect on our ability to successfully compete against other telecommunications service providers.

Competition for Long Distance Services. The long distance telecommunications industry has numerous entities competing for the same customers and a high average turnover rate, as customers frequently change long distance providers in response to the offering of lower rates or promotional incentives by competitors. Prices in the long distance market have declined significantly in recent years and we expect them to continue to decline. We expect to face increasing competition from companies offering long distance data and voice services over the Internet. Such companies could enjoy a significant cost advantage because there is considerable uncertainty about their obligation to pay carrier.

access charges or universal service fees. In addition to these competitors, wireless competitors and long distance carriers such as AT&T, WorldCom and Sprint, we also face competition from the RBOCs—the FCC has granted approval to the RBOCs to provide long distance service in 37 states and the District of Columbia so far.

Competition for Data/Internet Services. The Internet services market is highly competitive and there are limited barriers to entry. We expect competition to continue to intensify, including as a result of the development of new technologies. Competitors in this market include Internet service providers, other telecommunications companies, online service providers and Internet software providers. Most of the RBOCs now offer high speed data services.

Competition for Customer Premise Equipment Sales and Maintenance. Our Shared Technologies subsidiary competes mainly with the RBOCs, Nextera and local companies that provide customer premises equipment sales and maintenance services in each of our markets. The barriers to entry in this marketplace are relatively low and competition is high. Given that most competitors sell the same type of customer premises equipment, price becomes one of the key factors in the marketplace. Shared Technologies tries to offset the price pressure by focusing on services that differentiate it from its competitors, by developing products such as KTWare and providing services such as eBook and the Guardian Service plan, as described under the caption "Information Systems—Other Systems."

Competition from International Telecommunications Providers. Under the World Trade Organization agreement on basic telecommunications services, the United States and 72 other members of the World Trade Organization committed themselves to opening their respective telecommunications markets and/or relaxing foreign ownership restrictions and/or to adopting regulatory measures to protect competitors against anticompetitive behavior by dominant telecommunications companies, effective in some cases as of January 1998. Although we believe that this agreement could provide us with significant opportunities to compete in markets that were not previously accessible and to provide more reliable services at lower costs than we could have provided prior to implementation of this agreement, it could also provide similar opportunities to our competitors and facilitate entry by foreign carriers into the U.S. market. There can be no assurance that the pro-competitive effects of the World Trade Organization agreement will not have a material adverse effect on our business, financial condition and results of operations or that members of the World Trade Organization will implement the terms of this agreement.

EMPLOYEES

As of December 31, 2002, we had 3,814 employees, down from 4,140 on December 31, 2001. Of the 3,814 employees as of December 31, 2002, 1,118 were in sales and sales administration and 733 were in our Shared Technologies subsidiary. Certain of our employees in our Shared Technologies subsidiary are covered by a collective bargaining agreement. Management believes the company's relationship with its employees is good.

RISK FACTORS

If we cannot reduce our debt as required by our senior secured credit agreement, or enter into an amendment or obtain a waiver, we will be in default under the terms of that agreement and our senior lenders may request immediate repayment of our senior debt which may result in a foreclosure proceeding or voluntary or involuntary bankruptcy filing. Under the interim amendment that we signed on November 27, 2002, our consolidated total debt cannot exceed at any time (i) \$1.275 billion from November 27, 2002 through April 29, 2003 and (ii) \$645 million thereafter. To reduce our debt, we or our affiliates may from time to time purchase such debt for cash, exchange them for our common stock and/or another debt or equity security or acquire such debt for a combination of cash and common stock and/or another debt or equity security, in each case in open market purchases, in privately negotiated transactions, through exchange offers or in a negotiated or prepackaged bankruptcy proceeding. We are currently evaluating such transactions and other potential recapitalization plans in light of the requirements under our senior credit agreement, existing market conditions, current and projected liquidity, other contractual restrictions, current and projected operating performance and other factors. The amount of cash used, debt incurred or securities issued in any such transactions, individually or in the aggregate, may be material as well as the related dilution to common stockholders. **If we cannot reduce our debt to the required levels by April 30, 2003 or enter into an amendment or obtain a waiver, we will be in default under our senior credit agreement.** In addition, if we do not enter into a permanent amendment to our senior credit agreement before May 1, 2003 or enter into an amendment or obtain a waiver, we will be in default under that agreement. Under the terms of our senior credit agreement, we are required to deliver an unqualified audit report to our senior lenders. We have received an audit report that is modified to express substantial doubt about our ability to continue as a going concern. As such, if we do not receive a waiver from our senior lenders or if we are unable to cure this breach within 30 days, there will be an event of default under our senior credit agreement. **If any default described in this paragraph occurs, our senior lenders would have the right to request immediate repayment of our senior debt, in which case, our bondholders would then have the right to request immediate repayment of our bonds.**

Our senior lenders could also prevent us from making the interest payment on our 12⁷/₈% bonds due May 15, 2003. If this interest payment has not been made by the end of the 30 day cure period, we will also be in default under our 12⁷/₈% bond indenture which may trigger acceleration of the repayment of our debt to the 12⁷/₈% bondholders, our 11³/₄% bondholders and our senior lenders.

If any of the above described acceleration events occur, this would have a material adverse effect on us and may result in a foreclosure proceeding and/or voluntary or involuntary bankruptcy filing. We may also determine, based on the factors listed above as well as the terms and conditions of any proposed recapitalization, that it would be advisable to reduce our debt to a greater extent than that required by the interim amendment. This determination would involve a reduction in our senior secured debt and any such reduction would substantially reduce the value of our other debt securities and our common stock, potentially to zero.

Limitations imposed by restrictive covenants limit how we conduct business and a default under our indentures and financing agreements could have a material adverse effect on us. Our indentures and our credit facilities contain covenants that restrict our ability to

- incur additional indebtedness,
- pay dividends and make other distributions,
- prepay subordinated indebtedness,
- make investments and other restricted payments,
- enter into sale and leaseback transactions,

- create liens,
- sell assets, and
- engage in certain transactions with affiliates

Our indentures provide that upon a change of control, each note holder will have the right to require us to purchase all or a portion of such holder's notes. Our senior credit agreement provides that upon a change of control, we may be required to repay all of our obligations under this agreement. Our current and future financing arrangements contain and will continue to contain similar or more restrictive covenants, as well as other covenants that require us to maintain specified financial ratios and satisfy financial tests, including those discussed above. Our failure to comply with the covenants and restrictions contained in our senior secured credit facilities and indentures could lead to default under the terms of these agreements. If such a default occurs under the credit agreement, our senior lenders would have the right to request immediate repayment of our senior debt, in which case, our bondholders would then have the right to request immediate repayment of our bonds. In addition, lenders under our current and future financing arrangements could terminate their commitments to lend to us. If any of these events occur, they would have a material adverse effect on us and may result in a foreclosure proceeding and/or voluntary or involuntary bankruptcy filing.

Some of our vendor contracts also allow vendors to demand additional security, which may include letters of credit or other financial instruments. Our ability to give such additional security may be limited by our financing agreements. Accordingly, we may not be able to give the financial security that our vendors may be demanding and the vendors may refuse to do additional business or terminate existing relationships. Refusal to provide additional services and/or termination of existing relationships could have a material adverse impact on our business and future prospects.

Under certain circumstances, we may need additional capital and such capital may not be available. As discussed above, we must reduce our debt to no more than \$645 million by April 30, 2003. If we are required to use any of our existing cash to repay some or all of our senior debt or bonds, we cannot assure you that we will be able to obtain alternative financing. Even if we could obtain alternative financing, we cannot assure you that it would be on terms that are favorable to us. If we cannot obtain alternative financing when needed, this would have a material adverse effect on us. Even if we reduce our debt to an acceptable level, we may need additional capital to fund capital expenditures, working capital, debt service and cash flow deficits to operate our business and to deploy our networks, services and systems. In the event we have to repay amounts borrowed under our financing agreements earlier than expected or if our estimates of capital requirements and revenues are inaccurate, we may need to access alternative sources of capital, reduce or delay capital expenditures, sell assets, refinance or restructure our debt and/or modify our business plan, which may have a material adverse effect on us.

Our common stock and high-yield bonds are securities of our holding company and have no direct claims on our assets. We operate our business through subsidiaries and have no material assets at our holding company, Allegiance Telecom, Inc., other than the common stock of our main operating company, Allegiance Telecom Company Worldwide. Our holding company is the issuer of our common stock and our high-yield bonds. These securities are not guaranteed by any of our operating subsidiaries and therefore have no claims against our assets. As such, all of our assets are subject to the claims of our senior secured creditors and other creditors at our subsidiary operating companies. Moreover, the only material asset of our holding company, the common stock of our main operating company, Allegiance Telecom Company Worldwide, is pledged as collateral to our senior secured creditors. If we were to file for protection from our creditors in a bankruptcy proceeding and the value of our business were determined to be less than the amount of claims of our senior lenders and other creditors at our operating subsidiaries, our common stock and high-yield bonds would have no value. Moreover, even if the value of our business were determined to exceed these claims, a possible

outcome of a bankruptcy proceeding is to require the conversion of some or all of such senior debt to equity and as a result, the holders of our high-yield bonds and common stock may receive little value, if any

We anticipate having future operating and net losses. We have incurred operating and net losses every year since we began operations. We have invested significant amounts of capital and other expenditures in developing our business and deploying our networks, systems and services and we will continue to invest capital for the operation of our business. We will continue to have significant operating and net losses in our business until we establish a sufficient revenue-generating customer base to cover our costs. For the year ended December 31, 2002, we had net operating losses of \$471.2 million and net losses applicable to common stock of \$572.7 million. We can make no assurances that we will achieve or sustain profitability or generate sufficient operating income to meet our working capital, capital expenditure and debt service requirements, and if we are unable to do so, this would have a material adverse effect on our business, financial condition and results of operations.

Our customer contract with Level 3 Communications represented 12% of our total revenues for 2002 and the loss of this customer would materially and adversely impact our business. Our largest customer is Level 3 Communications, Inc., who is the assignee of Genuity Solutions Inc.'s interest in the Genuity/Allegiance Integrated Network Solution Purchase Agreement. Revenues from this contract were \$90.3 million and \$46.8 million for the years ended December 31, 2002 and 2001, respectively. This represented 12% and 9% of our total revenues for those years ended, respectively, and 33% and 29% of our data revenues for the same periods. We anticipate that Level 3 will continue to be our largest customer for the foreseeable future. Our failure to meet the performance warranties under this contract may allow Level 3 to offset future payments to us and, if such failure continues for an extended period of time, Level 3 could terminate this contract. The resulting reduction in revenue and/or loss of this contract would have a material adverse effect on us. Please see the discussion of this customer contract under "Management's Discussion and Analysis of Financial Condition and Results of Operations."

If we are delisted from Nasdaq, the liquidity and market price of our common stock may be adversely affected. Our common stock is currently traded on the Nasdaq National Market. We received a notice from Nasdaq dated January 22, 2003 indicating that we were not in compliance with Nasdaq's Marketplace Rule 4450(a)(5), because our common stock failed to maintain the minimum bid price of \$1.00 during the prior 30 consecutive trading days. If compliance with that rule cannot be demonstrated by April 22, 2003, the Nasdaq Staff will provide written notification to us that our securities will be delisted. At that time, we may appeal the Staff's determination to a Listing Qualifications Panel. We plan on applying to transfer our common stock to The Nasdaq SmallCap Market prior to April 22, 2003 and initiation of the delisting proceedings will be stayed pending the Staff's review of our transfer application. In order to transfer to the SmallCap Market, we must satisfy the continued listing requirements for that market. If our transfer application is approved, we will be afforded the 180 calendar day SmallCap Market grace period for the minimum \$1.00 bid price requirement, or until July 21, 2003. We may also be eligible for an additional 180 calendar day grace period provided that we meet the initial listing criteria for the SmallCap Market under Marketplace Rule 4310(c)(2)(A). There can be no assurances that we will be able to maintain compliance with that rule or any other Nasdaq listing rule. Nasdaq's Marketplace Rules provide that a company may be delisted in the event that it files for bankruptcy protection. If our common stock is delisted from Nasdaq, this will likely result in decreased liquidity of our common stock. The delisting of our common stock could also deter broker-dealers from making a market in or otherwise generating interest in our common stock and could adversely affect our ability to attract investors in our common stock and raise additional capital. As a result of these factors, the value of our common stock could decline significantly, and our stockholders could lose some or all of their investment.

The regulation of interconnection with incumbent local carriers involves uncertainties, and the resolution of these uncertainties could adversely affect our business. Although the incumbent local carriers are required under the Telecommunications Act of 1996 to unbundle and make available elements of their network and permit us to purchase only the origination and termination services that we need, thereby decreasing our capital and operating expenses, such unbundling may not be done as quickly as we require and may be priced higher than we expect. This is important because we rely on the facilities of these other carriers to provide services to our customers. Our ability to obtain these interconnection agreements on favorable terms, and the time and expense involved in negotiating them, can be adversely affected by legal and regulatory developments.

The United States Supreme Court vacated a FCC rule determining which network elements the incumbent local carriers must provide to competitors on an unbundled basis. On November 5, 1999, the FCC released an order revising its unbundled network element rules to conform to the Supreme Court's interpretation of the law, and reaffirmed the availability of the unbundled network elements, including local loops and dedicated transport, the principal elements used by us. We use unbundled local loops and unbundled high capacity digital loops to connect our customer locations to our voice and data transmission equipment colocated in the incumbent local carriers' central offices, and dedicated transport to connect our transmission equipment to our switches and data equipment which are generally located at our central offices. The FCC also stated its intention to review every three years the unbundling obligations of incumbent local exchange carriers. The U.S. Court of Appeals for the District of Columbia Circuit remanded, but did not vacate, the FCC's Order on May 24, 2002. The FCC's request for rehearing of that decision was denied, but the Court agreed to delay until February 20, 2003 the issuance of the mandate. On February 20, 2003, the FCC announced its decision in the triennial review, but the text of the decision has not yet been released. While these court and FCC proceedings were pending, we entered into interconnection agreements with a number of incumbent local carriers through negotiations or, in some cases, adoption of another competitive local carrier's approved agreement. These agreements remain in effect, although in some cases one or both parties may be entitled to demand renegotiation of particular provisions or of the entire agreement based on intervening changes in the law. However, it is uncertain whether any of these agreements will be so renegotiated or whether we will be able to obtain renewal of these agreements on as favorable terms when they expire.

Our facilities-based strategy allows us to control much of our network but we are still dependent on certain essential network elements that we lease from incumbent carriers. On December 20, 2001, the FCC released a Notice of Proposed Rulemaking as part of its comprehensive "triennial review" of the unbundling rules it implemented on November 5, 1999. In this review, the FCC examined the circumstances under which incumbent local exchange carriers will be required to make parts of their networks available to carriers like Allegiance on an unbundled basis under Section 251 of the Telecommunications Act of 1996. In particular, the FCC reviewed whether incumbents should be required to offer on an unbundled basis, among other things, local voice grade loops, high capacity loops such as those we use for many of our data and integrated voice and data services, subloops, network interface devices, the high-frequency portion of the loop, switching, and interoffice transmission facilities. The FCC announced its decision on February 20, 2003, but the text of the decision has not yet been released. A brief summary of our understanding of the results of the triennial review is provided under "Regulation—Federal Regulation." Any limitation on the availability of unbundled network elements, especially unbundled local loops, network interface devices or interoffice transmission facilities, could increase our costs and otherwise have a material adverse impact on our business.

On February 15, 2002, the FCC released a Notice of Proposed Rulemaking requesting comment on the future regulatory treatment of wireline broadband Internet access services. The FCC has tentatively concluded that when an entity provides wireline broadband Internet access over its own transmission

facilities, the service should be classified as an information service, rather than a telecommunications service. If the FCC adopts this conclusion, wireline broadband Internet access services provided by local exchange carriers would be subject to substantially less regulation, and this could result in the incumbent carriers not having to provide unbundled loops or unbundled high capacity digital loops over the lines used by us to provide broadband Internet access. We purchase unbundled high capacity digital loops from incumbent carriers to provide our own broadband Internet access service and integrated access service. While we cannot predict the outcome of this proceeding, any curtailment of the incumbent carriers' unbundling obligations for the loop component used by them to provide broadband Internet access services or changes in the cost basis therefore could materially increase our costs and adversely affect our ability to compete effectively with the incumbent carriers' broadband Internet access products.

The regulation of access charges involves uncertainties, and the resolution of these uncertainties could adversely affect our business. We earn "access charge" revenue by connecting our voice service customers to their selected toll and long distance carriers for outbound calls or by delivering inbound toll and long distance traffic to our voice service customers. Our interstate access charges were filed largely mirroring those used by the National Exchange Carrier Association ("NECA"), an association of independent local exchange carriers, and our state access charges were generally set at rates comparable to those set by state associations similar to NECA or of individual incumbent carriers operating in other areas within the same state. These charges are generally higher than those charged by the larger carriers operating in the same areas because these large carriers have many more customers and therefore have lower per unit costs. Access charges are intended to compensate the local exchange carrier for the costs incurred in originating and terminating toll and long distance calls on its network and we believe our access charges are appropriately set at levels approximately the same as those of the smaller carriers, but we anticipate that these rates will decline over time. Our switched access rates will have to be adjusted to comply with future decisions of the FCC or state commissions and these adjustments could have a material adverse effect on us.

On April 27, 2001, the FCC issued a Report and Order in the Access Charge Reform docket addressing competitive local exchange carrier interstate access charge rates. The FCC established safe harbor benchmark interstate rates that decrease over three years to the rates charged by incumbent local exchange carriers. The FCC stated that interexchange carriers must pay the benchmark rates for the interstate access services they receive or face suit in federal court. AT&T has appealed the FCC's Report and Order to the U.S. Court of Appeals for the District of Columbia Circuit. On April 27, 2001, the FCC also released a Notice of Proposed Rulemaking pursuant to which it is examining all forms of intercarrier compensation including access charges, and seeks comment on the feasibility of adopting a bill-and-keep approach for all such compensation. Federally-mandated reductions in access charges or adoption of a bill-and-keep approach could have a material adverse effect on us if we are unable to offset them with other revenues.

On May 31, 2002, WorldCom Network Services, Inc. filed an informal complaint against us at the FCC claiming that it is entitled to a refund of a portion of the interstate switched access charges paid by WorldCom to us prior to the effective date of the safe harbor benchmark rates that it alleges were unjust and unreasonable. Upon consideration of our answer to the complaint denying liability, the FCC declined to take further action on the informal complaint. WorldCom subsequently requested that the FCC host mediation discussions to explore settlement possibilities prior to its filing a formal complaint for refund against us. We are currently engaged in mediation with WorldCom. Although we believe that we have strong defenses to WorldCom's claims, we cannot predict the outcome of the litigation should the mediation be unsuccessful. If the mediation is not successful, we believe WorldCom might file a formal complaint against us at the FCC. WorldCom is seeking a refund of \$9.4 million plus interest. We are in discussions with WorldCom as to possible resolution of its claims, but we cannot provide any assurance that such negotiations will be successful.

On May 31, 2000, the FCC approved a proposal made by a coalition of the largest incumbent local carriers, AT&T and Sprint, to restructure interstate access charges. Pursuant to the proposal, certain incumbent carriers, designated as "price cap" incumbent local carriers, are required to reduce their interstate access rates to targeted levels approved by the FCC or submit cost studies to justify different rates. We anticipate that implementation of the FCC's decision will lead to an industry-wide reduction in interstate access rates, even by those carriers that are not bound by the decision, including smaller carriers. Reduction in interstate access rates will have a material adverse effect on us unless we are able to offset the access revenues with other revenues.

Several states in which we offer intrastate access services, including Colorado, Maryland, Massachusetts, Missouri, New Jersey, New York, Texas, Virginia and Washington, have proposed or required that access charges of competitive local carriers be capped at the rates charged by incumbent local carriers operating in the same area as the competitive local carriers with respect to calls originating or terminating in such area, except where the competitive carrier can establish that its costs justify a higher access rate through a formal cost proceeding. We believe that it is possible that other states will enact similar requirements. We also believe, however, that it is more likely that many states will use the same approach for intrastate long distance as the FCC ultimately decides to use for interstate long distance. If these proposals are adopted, they could have a material adverse effect on our revenues.

We could lose revenues if calls to Internet service providers are treated as long distance interstate calls. We earn "reciprocal compensation" revenue by terminating on our network, local calls that originate on another carrier's network. We believe that under the Telecommunications Act of 1996, other local exchange carriers should have to compensate us when their customers place calls to our customers who are Internet service providers. Most incumbent local carriers disagree. A majority of our reciprocal compensation revenues are a result from calls to our customers that are Internet service providers. Regulatory decisions providing that other carriers do not have to compensate us for these calls could limit our ability to service this group of customers profitably and could have a material adverse effect on us. Given the uncertainty as to whether reciprocal compensation should be payable in connection with calls to Internet service providers, we recognize such revenue only when realization of it is probable. In addition, the per minute compensation rates the FCC established for calls to Internet service providers under new interconnection agreements are significantly lower than the reciprocal compensation rates under our previous agreements. These reductions in compensation will have a material adverse effect on us if we are unable to offset them with other revenues.

The obligation to pay reciprocal compensation does not extend to long distance interstate calls. The FCC in its Declaratory Ruling of February 26, 1999, determined that Internet service provider traffic is interstate for jurisdictional purposes, but also determined that its current rules neither required nor prohibited the payment of reciprocal compensation for such calls. In the absence of a federal rule, the FCC determined that state commissions had authority to interpret and enforce the reciprocal compensation provisions of existing interconnection agreements and to determine the appropriate treatment of Internet service provider traffic in arbitrating new agreements. The Court of Appeals for the District of Columbia Circuit issued a decision on March 24, 2000, vacating the Declaratory Ruling. The court held that the FCC had not adequately explained its conclusion that calls to Internet service providers should not be treated as "local" traffic. On April 27, 2001, the FCC issued its Order on remand from the Court of Appeals and concluded that it had erred in its analysis of Internet traffic in the Declaratory Ruling. In that Order, the FCC categorized such traffic as "information access" and held that it is not subject to reciprocal compensation obligations. Nonetheless, it established an interim, transitional recovery mechanism pursuant to which Internet service provider traffic will continue to be compensated, but at rates declining over a period of three years. In a decision issued May 3, 2002, the U.S. Court of Appeals for the District of Columbia Circuit remanded for further proceedings, but did not vacate, the FCC's Order on remand, holding that the

section of the Act on which the FCC relied did not support its conclusion that Internet service provider traffic is not subject to reciprocal compensation. In a Notice of Proposed Rulemaking released April 27, 2001, the FCC initiated a rulemaking to examine all forms of intercarrier compensation, including reciprocal compensation, and sought comment on the feasibility of adopting a bill-and-keep approach for such compensation. Federally-mandated reductions in reciprocal compensation will have a material adverse effect on us if we are unable to offset them with other revenues. Additional disputes over the appropriate treatment of Internet service provider traffic are expected.

Our success depends on our key personnel and we may not be able to replace key employees who leave. We are managed by a number of key employees, most notably Royce J. Holland, our Chairman and Chief Executive Officer, who is widely recognized as one of the pioneers in managing providers of competitive local exchange services. The loss of services of one or more of these key individuals, particularly Mr. Holland, could materially and adversely affect our business and our prospects. Most of our key employees do not have employment agreements, and we do not maintain key person life insurance for any of our employees. We cannot assure you that we will be able to hire or retain necessary personnel in the future and if we are unable to do so, this could have a material effect on us.

We are dependent on effective billing, customer service and information systems and we may have difficulties in developing, maintaining and enhancing these systems. Sophisticated back office information and processing systems are vital to our growth and our ability to control and monitor costs, bill and service customers, initiate, implement and track customer orders and achieve operating efficiencies. We have introduced a new billing platform across our geographic markets. Although we are taking steps to manage the implementation of the new billing system and we believe that the new billing system will enhance our ability to accurately and efficiently bill for our services, we cannot assure you that the transition to the new billing system will not have any adverse impact on our business. We believe this new billing system will be more effective and accurate in delivering the quality billing functions that we need. Since our inception, we have also been engaged in developing and integrating our essential information systems consisting of our billing system, our sales order entry system, our customer implementation system, our electronic bonding systems and our switch information systems. In addition, we continue to integrate our acquired businesses. These are challenging projects because all of these systems were developed by different vendors and must be coordinated through custom software and integration processes. Our sales, line count and other core operating and financial data are generated by these systems and the accuracy of this data depends on the quality and progress of the system integration project. Although we have made significant progress in our system integration efforts, we have not completed it and we may experience additional negative adjustments to our financial and operating data as we complete this effort. These adjustments have not had a material adverse effect on our financial or operating data to date but until we complete the entire project we cannot assure you that any such adjustments arising out of our systems integration efforts will not have a material adverse effect in the future. If we are unable to develop, acquire and integrate our operations and financial systems, our customers could experience delays in connection of service, billing issues and/or lower levels of client service. We also cannot assure you that any of our systems will be successfully implemented on a timely basis or at all or will perform as expected because

- we have and will likely continue to have difficulties in getting products and services from our vendors delivered in a timely and effective manner, at acceptable costs and at the service and performance level required,
- we may fail to adequately identify all of our information and processing needs,
- our processing or information systems may fail or be inadequate,
- we may not be able to effectively integrate such products or services,
- we may fail to upgrade systems as necessary, and

- third party vendors may cancel or fail to maintain, renew or upgrade our license agreements that relate to these systems

Our failure to successfully implement these systems would have a material adverse effect on our business and prospects

We are dependent on many vendors and suppliers and their financial difficulties may adversely affect our business. We depend on many vendors and suppliers to conduct our business. For example, we purchase our network assets and customer premise equipment from equipment manufacturers and other suppliers and we lease fiber and other circuits from other carriers as well as from companies who construct these network elements for resale. Many of these third parties have experienced substantial financial difficulties in recent months, in some cases leading to bankruptcies and liquidations. In particular, the providers of fiber for our metropolitan fiber rings as well as our long-haul fiber routes have experienced financial difficulties, including difficulty in raising the necessary capital to complete fiber construction projects and in some cases filing for bankruptcy. The financial difficulties of these companies could have a material adverse effect on our business and prospects.

On February 14, 2003, Broadwing Communications Services, Inc., a supplier of long distance services to us, alleged that we were in material default of our Master Service Agreement with Broadwing. Broadwing is demanding \$6.6 million in disputed charges and is threatening to terminate service to our customers. Broadwing has also demanded an additional security deposit from us. In response, we sought and received a temporary restraining order and are in the process of negotiating an agreed preliminary injunction to prevent Broadwing from terminating our service, but there can be no assurance that we will be successful in obtaining the preliminary injunction. If we fail to get the preliminary injunction and Broadwing actually terminates long distance services to our customers, it could have a material adverse effect on our business. We have not included this dispute in network costs as of December 31, 2002, as we believe it is not probable that we will be required to pay this disputed amount.

Our financial results could be adversely affected by churn and the financial difficulties of our customers. We expect retail as well as retail and wholesale line churn to continue to average approximately 2% to 3% per month, which means that approximately 2% to 3% of our total number of retail/retail and wholesale lines in service would discontinue our service each month. However, our ability to retain our customers and control our churn rate (including line churn) is dependent on a number of factors, including (a) our ability to provide quality service, customer care and accurate and timely billing, (b) our ability to offer competitive pricing and overcome so called "win-back" programs offered by our competitors, (c) our ability to timely meet the needs and demands of our customers, (d) our ability to properly incentivize our sales force to build strong customer relationships, (e) the economic viability of our customers (see the discussion in the following paragraph) and (f) the strength and recovery of the United States economy. We can make no assurances that our churn rates (including line churn) will not increase. If our churn rates (including line churn) increase or are higher than expected, this could have a material adverse effect on our business and prospects.

We provide services to small and medium-sized businesses as well as network service providers. Many of these businesses have experienced substantial financial difficulties in recent months, in some cases leading to bankruptcies and liquidations. The financial difficulties of these companies could have a material adverse effect on our financial results if we are unable to collect revenues from these customers. In addition, among other things, we believe companies in financial difficulty are less likely to expand their operations and related demand for communications services and to migrate from dial-up Internet connections to more advanced dedicated connections such as those that we offer.

The financial difficulties of other competitive communications providers could adversely affect our business. Many competitive local exchange carriers, long distance carriers, and other emerging

communications providers have experienced substantial financial difficulties over the past year, in some cases leading to bankruptcies and liquidations. The financial difficulties of these companies could reflect poorly on our own financial stability, may diminish our ability to obtain further capital, may adversely affect the willingness of potential customers to move their communications services to an emerging carrier like Allegiance and may result in losses or write-offs of reciprocal compensation and access revenues from these carriers. Moreover, we have experienced efforts by established carriers to promote this problem and suggest to their customers that they should not risk placing their communications services in the hands of an emerging carrier. Some of our competitors have emerged from bankruptcy and others currently in bankruptcy may do so as well. Many of these companies have been able to reduce their debt and otherwise recapitalize their business and as a result, may be able to gain greater market share by reducing the prices for their products and services. These companies may be able to reduce their prices to a point lower than our prices and yet still be able to make a profit because of their reduced debt. We may lose business as a result of this price competition, and such loss of business may have a material adverse effect on us.

If we do not interconnect with and maintain efficient working relationships with our primary competitors, the incumbent local carriers, our business will be adversely affected. Many new carriers, including us, have experienced difficulties in working with the incumbent local carriers with respect to initiating, interconnecting, and implementing the systems used by these new carriers to order and receive unbundled network elements and wholesale services and locating the new carriers' equipment in the offices of the incumbent local carriers. As a competitive carrier, we must coordinate with incumbent local carriers so that we can provide local service to customers on a timely and competitive basis. The Telecommunications Act of 1996 created incentives for regional Bell operating companies to cooperate with competitive carriers and permit access to their facilities by denying such companies the ability to provide in-region long distance services until they have satisfied statutory conditions designed to open their local markets to competition. The FCC has granted approval to BellSouth and Verizon to provide in-region long distance service in every state where they operate. The FCC has granted approval to SBC Communications to provide in-region long distance service in California, Texas, Oklahoma, Missouri, Arkansas and Kansas, and to Qwest to provide such service in Montana, Utah, Washington, Wyoming, Colorado, Idaho, Iowa, Nebraska and North Dakota. Once authorized to provide long distance service, the RBOCs may have less incentive to be accommodating to us. In addition, these companies may limit the development of their systems that they were doing prior to being permitted to offer long distance services.

The regional Bell operating companies have been fined numerous times by both federal and state authorities for their failure to comply with applicable telecommunications laws and regulations. We do not believe these fines have had any meaningful impact on the anticompetitive practices of many of these companies and in fact believe that these practices are increasing in most of our markets. We attempt to enforce our rights against these incumbent monopolies but often times the remedies are inadequate to change their anticompetitive practices and in any event provide us with little or no recovery of the damages we have suffered as a result of these practices. Moreover, efforts by us to enforce our rights against these companies may further diminish the level of cooperation we receive from them. If we cannot obtain the cooperation of a regional Bell operating company in a region, whether or not it has been authorized to offer long distance service or a regional Bell operating company otherwise fails to meet our requirements, for example, because of (1) labor shortages, (2) work stoppages or (3) disruption caused by mergers or other organizational changes or terrorist attacks, our ability to offer local services in such region on a timely and cost-effective basis will be materially adversely affected.

We have experienced difficulties also with receiving payment from the incumbent local exchange carriers on reciprocal compensation, access charges, and other services provided by us to them. These balances in some instances may be significant and material. We have generally been able to reach

mutually acceptable settlements of these amounts, but there can be no assurance that we will be able to do so in the future. If we are unable to reach settlement agreements for the incumbent local exchange companies to pay amounts owed to us, it could have a material adverse effect on us. In addition, some of our interconnection agreements allow the incumbent local exchange carriers to increase the security amount held by them. If we are forced by the local exchange companies to increase our security, this would reduce the amount of cash available for expenses of our business which could have a material adverse effect on our business.

Our principal competitors for local services, the incumbent local carriers, and potential additional competitors, have advantages that may materially adversely affect our ability to compete with them. The telecommunications industry is highly competitive. In each of the markets targeted by us, we will compete principally with the incumbent local carrier serving that area. Many of our current and potential competitors in the local market have financial, technical, marketing, personnel and other resources, including brand name recognition, substantially greater than ours, as well as other competitive advantages over us. Incumbent local carriers also enjoy other advantages that may adversely affect our ability to compete with them, such as our need to purchase critical elements of our network from them. Incumbent local carriers are established providers of local telephone services to all or virtually all telephone subscribers within their respective service areas. Incumbent local carriers also have long-standing relationships with federal and state regulatory authorities. FCC and state administrative decisions and initiatives provide the incumbent local carriers with pricing flexibility for their

- private lines, which are private, dedicated telecommunications connections between customers,
- special access services, which are dedicated lines from a customer to a long distance company provided by the local phone company, and
- switched access services, which refers to the call connection provided by the local phone company's switch between a customer's phone and the long distance company's switch.

In addition, with respect to competitive access services, such as special access services as opposed to switched access services, the FCC recently granted incumbent local carriers increased pricing flexibility and deregulation for such access services after certain competitive levels are reached. If the incumbent local carriers are allowed by regulators to offer discounts to large customers through contract tariffs, engage in aggressive volume and term discount pricing practices for their customers, and/or seek to charge competitors excessive fees for interconnection to their networks or access to unbundled network elements, competitors such as us could be materially adversely affected. If future regulatory decisions afford the incumbent local carriers increased pricing flexibility or other regulatory relief, such decisions could also have a material adverse effect on competitors such as us.

We also face, and expect to continue to face, competition in the local market from other current and potential market entrants, including long distance carriers seeking to enter, reenter or expand entry into the local exchange marketplace such as AT&T, WorldCom and Sprint, and from other competitive local carriers, wireless carriers, resellers, competitive access providers, cable television companies, electric utilities, microwave carriers and private networks built by large end users. In addition, the development of new technologies could give rise to significant new competitors in the local market.

Significant competition in providing long distance and Internet services could reduce the demand for and profitability of our services. We also face significant competition in providing long distance and Internet services. Many of these competitors have greater financial, technological, marketing, personnel and other resources than those available to us.

The long distance telecommunications market has numerous entities competing for the same customers and a high average turnover rate, as customers frequently change long distance providers in response to the offering of lower rates or promotional incentives. Prices in the long distance market

have declined significantly in recent years and are expected to continue to decline. We face competition from large carriers such as AT&T, WorldCom and Sprint, wireless carriers and many smaller long distance carriers. Other competitors include regional Bell operating companies providing long distance services outside of their local service area and, with the removal of regulatory barriers, long distance services within such local service areas, other competitive local carriers, microwave and satellite carriers and private networks owned by large end users. The FCC has granted approval to provide in-region long distance service to BellSouth and Verizon in all of their states, to SBC Communications in California, Texas, Oklahoma, Missouri, Arkansas and Kansas, and to Qwest in Montana, Utah, Washington, Wyoming, Colorado, Idaho, Iowa, Nebraska and North Dakota. We may also increasingly face competition from companies offering local and long distance data and voice services over the Internet. Such companies could enjoy a significant cost advantage because they do not currently pay many of the charges or fees that we have to pay.

The Internet services market is highly competitive and there are limited barriers to entry. We expect that competition will continue to intensify. Our competitors in this market include Internet service providers, other telecommunications companies, online service providers, cable companies, and Internet software providers.

Our need to comply with extensive government regulation can increase our costs and slow our growth. Our networks and the provision of telecommunications services are subject to significant regulation at the federal, state and local levels. Delays in receiving required regulatory approvals or the enactment of new adverse regulation or regulatory requirements may slow our growth and have a material adverse effect upon us.

The FCC exercises jurisdiction over us with respect to interstate and international services. We must obtain, and have obtained through our subsidiary, Allegiance Telecom International, Inc., prior FCC authorization for installation and operation of international facilities and the provision, including by resale, of international long distance services.

State regulatory commissions exercise jurisdiction over us because we provide intrastate services. We are required to obtain regulatory authorization and/or file tariffs at state agencies in most of the states in which we operate. If and when we seek to build our own network segments, local authorities regulate our access to municipal rights-of-way. Constructing a network and selling telephone equipment is also subject to numerous local regulations such as building codes and licensing. Such regulations vary on a city by city and county by county basis. In some states, we are required to obtain state contractor licenses. If we do not obtain such required licenses, we may be subject to fines and other penalties.

Regulators at both the federal and state level require us to pay various fees and assessments, file periodic reports, and comply with various rules regarding the contents of our bills, protection of subscriber privacy, service quality and similar matters on an ongoing basis.

We cannot assure you that the FCC or state commissions will grant required authority or refrain from taking action against us if we are found to have provided services without obtaining the necessary authorizations, or to have violated other requirements of their rules and orders. Regulators or others could challenge our compliance with applicable rules and orders. Such challenges could cause us to incur substantial legal and administrative expenses and cause material adverse effects.

Deregulation of the telecommunications industry involves uncertainties, and the resolution of these uncertainties could materially adversely affect our business. The Telecommunications Act of 1996 remains subject to judicial review and additional FCC rulemaking, and thus it is difficult to predict what effect the legislation will have on us and our operations. There are currently many regulatory actions underway and being contemplated by federal and state authorities regarding interconnection pricing, access to and pricing for unbundled network elements and other issues that could result in significant changes to the business conditions in the telecommunications industry. We cannot assure you

that these changes will not have a material adverse effect upon us. On February 20, 2003, the FCC announced its decision in its triennial review of the obligations of incumbent carriers to provide competitors access to unbundled network elements. A brief summary of that decision is provided under "Regulation—Federal Regulation."

We continue to monitor our network from a performance and cost perspective and as a result, our network optimization routines may have an adverse effect on our customers. Our engineering and operations organizations continually monitor and analyze the utilization of our network. As a result, they may develop projects to modify or eliminate network circuits that are underutilized. This ongoing process may result in limited network outages for a subset of our customers, adversely affecting our relationship with them and may increase our customer disputes and/or customer churn.

Our past and future acquisitions may be difficult to integrate, disrupt our business, dilute our stockholders and divert management attention. We have acquired a number of companies as part of our business plan, especially companies that provide Internet and web hosting services. We may acquire or invest in additional businesses that we believe could complement or expand our business, augment our market coverage, enhance our service offerings or that may otherwise offer other opportunities. Acquisitions involve risks and present issues, including, among others:

- the difficulty of integrating the acquired operations, including provisioning, billing and customer service systems,
- the diversion of personnel from other business concerns and potential disruption of our ongoing business,
- expectations of financial results not being met,
- unanticipated costs associated with acquisitions,
- the difficulty in combining the service offerings of the acquired company with our existing service offerings,
- the inability of management to maintain uniform standards, controls, procedures and policies;
- the risks of entering businesses and markets in which we have little or no direct prior experience,
- the impairment of relationships with employees or customers of the acquired company as a result of changes in management or otherwise arising out of such transactions,
- use of some of our available cash to purchase these businesses, and
- dilution of current stockholders due to issuances of additional securities as consideration for acquisitions.

We can make no assurances that we will be able to successfully integrate acquired businesses or operations that we have acquired or that we may acquire in the future. In addition, we may not achieve the anticipated benefits from our acquisitions. If we fail to achieve the anticipated benefits from such acquisitions, we may incur increased expenses and experience a shortfall in our anticipated revenues and we may not obtain a satisfactory return on our investment.

Our stock has been extremely volatile. Our stock has experienced significant price and volume fluctuations, often times due to factors beyond our control. Given that our stock is thinly traded, sales by even a single large stockholder can materially decrease our market price. The market price for our common stock may continue to be subject to wide fluctuations in response to a variety of other factors, including but not limited to the following, some of which are beyond our control:

- outcome or anticipated outcome of our recapitalization,

- revenues and operating results of our company or other emerging communications companies failing to meet the expectations of securities analysts or investors or be in compliance with bank covenants in any period,
- failure to successfully implement our business strategy;
- changes in regulatory requirements or adverse regulatory orders or court decisions,
- announcements of operating results and business conditions by our customers and competitors,
- financial difficulties of our customers and competitors,
- technological innovations by competitors or in competing technologies,
- announcements by us or our competitors of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments,
- announcements by third parties of significant claims or proceedings against us,
- investor perception of our industry or our prospects,
- economic developments in the telecommunications industry or general market conditions,
- margin loan requirements applicable to our stockholders,
- possible or actual de-listing from Nasdaq, or
- events such as the September 11, 2001 terrorist attacks in the United States or war with other countries

Future sales of our stock by existing stockholders may adversely affect our stock price. As of March 26, 2003, we had 124,778,137 shares of common stock outstanding and 19,907,730 shares of common stock reserved for issuance upon exercise of outstanding stock options and warrants. Many of our outstanding shares are "restricted securities" under the federal securities laws, and such shares are or will be eligible for sale subject to restrictions as to timing, manner, volume, notice and the availability of current public information regarding Allegiance. Many of our outstanding shares are held by our founding management team and venture capital investors. Sales of substantial amounts of stock in the public market or sales of stock by our founding management team and venture capital investors, the perception that these sales could occur, could depress the prevailing market price for all of our securities. Sales of substantial amounts of stock by these stockholders in the public market may also make it more difficult for us to sell equity securities or equity-related securities in the future at a time and price that we deem appropriate and, to the extent these sales depress our common stock price, may also increase the amount of dilution suffered by existing stockholders in connection with any recapitalization which involves an exchange of debt for equity or equity-related securities or the offering of additional equity securities.

Anti-takeover provisions in our charter and bylaws could limit our share price and delay a change of management. Our charter and bylaws contain provisions that could make it more difficult or even prevent a third party from acquiring our company without the approval of our incumbent board of directors. In addition, our credit facilities and some of our other agreements may discourage a change in control.

ITEM 2. PROPERTIES

We own or lease, in our operating territories, telecommunications property which includes

- owning switches and other telecommunications equipment,
- leasing high capacity digital lines that interconnect our network together and with incumbent local carrier networks,
- *leasing high capacity digital lines that connect our switching equipment to our transmission equipment located in incumbent local carrier central offices,*
- leasing local loop lines which connect our customers to our network, and
- leasing space in incumbent local carrier central offices for collocating our transmission equipment

We are headquartered in Dallas, Texas and lease offices and space in a number of locations, primarily for sales offices and network equipment installations. We own a parcel of land in Dallas, Texas, which is located next to our headquarters and such land is pledged to our senior lenders as security under our senior credit facilities. Our network operations control centers are located in Dallas, Texas and Greenbelt, Maryland. We have some leased facilities that we are not currently occupying (including as a result of our purchase of the Shared Technologies CPE assets from WorldCom in June 2002 and integration of the personnel working at those sites into our existing facilities) and are in the process of subleasing those facilities.

We believe that our leased facilities are adequate to meet our current needs in our operational markets.

ITEM 3. LEGAL PROCEEDINGS

We are not party to any legal proceeding that we believe would, individually or in the aggregate, have a material adverse effect on our financial condition or results of operations.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

We did not submit any matter to a vote of our stockholders during the fourth quarter ended December 31, 2002.